[2019] UKFTT 689 (TC)

TC07462

TONNAGE TAX – whether liable to a balancing charge on sale of asset following exit to tonnage tax regime – no – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2018/3378

BETWEEN

UNICORN TANKSHIPS (428) LTD **Appellant**

-and-

THE COMMISSIONERS FOR
HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: JUDGE AMANDA BROWN

Sitting in public at Taylor House, 88 Rosebery Avenue, London EC1R 4QU on 17 – 19 July 2019

Mr Francis Fitzpatrick QC, counsel, instructed by BDO LLP for the Appellant

Ms Elizabeth Wilson and Mr Charles Bradley, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs for the Respondents

DECISION

INTRODUCTION

1. This case concerns an appeal by Unicorn Tankships (428) Ltd ("**UT428**") against a closure notice issued by HM Revenue & Customs ("**HMRC**") amending UT428's corporation tax return for the period ended 31 December 2010 so as to bring into account a balancing charge of £12,579,499 on UT428's disposal of a ship known as the Nyathi (**"the Ship"**).

AGREED FACTS

2. There was no dispute between the parties as to the facts relevant to determination of the appeal which were set out in a statement of agreed facts. Set out below are the facts as agreed (terms modified to reflect those used in this judgment):

UT428

(1) UT428 is a limited company incorporated in the British Virgin Islands.

(2) It was incorporated on 21st May 2003.

(3) From the date of its incorporation until 31st December 2010, it was managed and controlled in the United Kingdom. It was resident in the United Kingdom for the purposes of corporation tax from the date of its incorporation until 31 December 2010.

The Group

(4) UT428's direct parent is Unicorn Tankers (International) Limited ('**UTI**'). UTI is the holding company of a UK resident sub-group of the worldwide group. The UK resident sub-group is known as the ("**the Unicorn Tonnage Tax Group**").

(5) The parent company of the worldwide group is Grindrod Limited (a South African company listed on the Johannesburg Stock Exchange)[1].

The tonnage tax group election

(6) A tonnage tax election ('**the Group Election**') was made in respect of the Unicorn Tonnage Tax Group on 19th September 2001 with effect from 1st January 2001.

The Ship

(7) On 14 June 2002, UTI entered into a shipbuilding contract for the construction of the Ship.

(8) Subsequently, UTI assigned the shipbuilding contract to another group company, Unicorn Bulk Carriers Limited ('**UBC**'). UBC was incorporated on 4 September 2002. From its incorporation it was a member of the Unicorn Tonnage Tax Group. UBC operated one vessel from its incorporation and another shortly thereafter.

(9) UBC never brought the Ship into use as part of its tonnage tax trade or otherwise. UBC never claimed and was never entitled to claim capital allowances in respect of the Ship.

(10) UT428 acquired the Ship from UBC on 22nd June 2004.

(11) UT428, on acquiring and operating the Ship, became a qualifying company and subject to the tonnage tax regime (**"the TTR"**).

(12) During the material period, UT428 did not own any other vessel.

[1] With effect from June 2018, the parent company of the worldwide group was Grindrod Shipping Holdings Limited, a Singaporean company listed on NASDAQ and the Johannesburg Stock Exchange.

(13) The acquisition price of the Ship was $25,320,135.

Time Charters of the Ship

(14) On delivery to UT428, the Ship was immediately subject to a time charter with Eni Spa Refining. This charter came to an end on 27th August 2007.

(15) It was then time chartered for a single voyage to the USA.

(16) Subsequently, it was time chartered to from 5th October 2007 to 26th November 2007 to Silver Fern Shipping Limited ("**Silver Fern**").

Bareboat charter of the Ship

(17) From 26th November 2007, it was bareboat chartered ('**the Bareboat Charter**') to Nyathi Shipping BV (a company associated with Silver Fern) ('**the Bareboat Charterer**'). Nyathi Shipping BV is not connected to UT428. The Bareboat Charter was for three years. The Bareboat Charterer had an option to extend the term of the Bareboat Charter by two years and a further option to extend by a further two years.

(18) On 21st June 2010, the Bareboat Charterer exercised the option to extend the period of the Bareboat Charter by two years.

(19) As a result, the term of the Bareboat Charter then exceeded three years and this meant that UT428 was no longer operating a qualifying vessel for the purposes of Tonnage Tax. UT428 thereby ceased to be a qualifying company with the consequence that UT428 left the TTR on 21st June 2010.

Sale of the Ship by the UT428

(20) On 17th November 2010, the Appellant, Nyathi Limited (a member of the Grindrod Group) and Nyathi Shipping BV (as Bareboat Charterer) entered into a charter novation agreement in order to novate the Bareboat Charter to Nyathi Limited.

(21) On 13 December 2010, the Appellant and Nyathi Limited entered into a Memorandum of Agreement to sell the Ship to Nyathi Limited. This Agreement took effect on 31st December 2010.

(22) The sale price for the Ship and the Bareboat Charter was $28.5m.

(23) The disposal proceeds of the Ship were $23,250,000 (the remainder being attributable to the Bareboat Charter). This was the market value of the Ship at the date of its disposal.

(24) On 17th December 2010, the Appellant and Nyathi Limited entered into a business transfer agreement to transfer other assets and liabilities from UT428 to Nyathi Limited. This Agreement took effect on 31 December 2010.

No capital allowances have been claimed in respect of the Ship

(25) UT428 has not claimed any capital allowances in respect of the Ship.

(26) No capital allowances in respect of the Ship have been claimed by UTI, UBC or Nyathi Limited.

OUTLINE OF THE TONNAGE TAX REGIME

3. The TTR is a scheme providing for favourable taxation of the UK maritime fleet and constitutes a regime of approved state aid. It was introduced pursuant to the terms of Schedule 22 Finance Act 2009 ("**Sch 22**"), and was subject to amendment in 2005.

4. In summary, shipping companies which elect into the TTR pay corporation tax on their tonnage tax profits[2] in place of corporation tax on the relevant shipping profits[3]. In essence, under the TTR, corporation tax is payable applying the normal rate of corporation tax on a deemed daily profit calculated by reference to the net tonnage of vessels operated by the shipping company. Tonnage tax is payable irrespective of the profitability of the trade associated with the operation of the vessels concerned and, in the case of otherwise profitable activity, tax payable under the TTR will usually be significantly lower than tax payable on the profits of the trade.

5. TTR is a ring-fenced regime which explicitly envisages that there shall be a general exclusion of reliefs and deductions[4].

6. In order to enter the TTR, a shipping company must operate qualifying ships (broadly seagoing ships of 100 tons or more gross tonnage used for the carriage by sea of passengers or cargo); undertake the strategic and commercial management of the vessels in the UK[5], and enter into a training commitment to train a minimum of 1 in 15 UK/EEA officers (subject to a minimum of 1)[6]. Certain EU/EEA 'flagging' (registration) rules must also be met. These requirements were set in order to ensure compliance with the EU Commission's state aid approval of the TTR.

7. A tonnage tax election is made in respect of a group and the election has effect in respect of to all qualifying companies[7]. The tonnage tax election lasts for 10 years and cannot be revoked.[8]

8. As the TTR is a favourable regime it is specifically subject to anti avoidance provisions contained in paragraphs 41 and 42 Sch 22. Paragraph 41 makes it a condition of remaining within the TTR that a company is not party to any transaction or arrangement that is an abuse of the regime. Paragraphs 42, 138 and 139 Sch 22 result in the exclusion of any company which is involved in a prohibited transaction or arrangement from the TTR and the imposition of exit charges.

9. More details of the provisions of Sch 22 lying at the heart of the present dispute are set out in [25] – [34] below.

RELEVANT LEGISLATION

10. For the purposes of the present appeal the critical provisions to be considered and interpreted are contained in Capital Allowances Act 2001 ("**CAA**") and Sch 22. In this judgement, any section number is a reference to the CAA and any paragraph number is a reference to Sch 22.

CAA

11. Without the provisions of the CAA, expenditure on capital assets would not be set against revenue profits. The CAA sets out the basis of, and mechanics by which, allowance is given for capital expenditure, so far as relevant in this appeal, on plant and machinery.

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[2] As defined in paragraph 4 Sch 22.

[3] As defined in Part VI Sch 22.

[4] See paragraph 55 Sch 22.

[5] See paragraph 16 Sch 22.

[6] See part IV Sch 22 and Tonnage Tax (Training Requirements) Regulations 2000/2129.

[7] See paragraphs 7 and 19 Sch 22 – i.e. companies operating seagoing ships of 100 tons or more used for, inter alia, the carriage of cargo by sea.

[8] In 2005 when changes were made to the terms of the TTR a limited right to revocation of the Tonne Tax Election was introduced. It is not relevant in the facts of this appeal.

12. The capital allowances regime provided for under the CAA provides a statutory right, rather than an obligation, to claim allowances for capital expenditure. The CAA prescribes the circumstances and methodology for a claim to capital allowances in a prescriptive and formulaic way.

13. Section 11 provides that allowances are available under Part 2 of the CAA if a person "carries on a qualifying activity and incurs qualifying expenditure". Section 11(4) defines "qualifying expenditure" and section 15(1) defines "qualifying activities".

14. The general rule for qualifying expenditure ("**QE**") (as set out in s11(4)) is that it is "capital expenditure on the provision of plant or machinery wholly or partly for the purpose of the qualifying activity carried on by the person incurring the expenditure" where the person incurring the expenditure owns the plant or machinery as a result of incurring it.[9]

15. Pursuant to s13, where a person brings plant or machinery previously used for a non-qualifying activity into use for the purposes of a qualifying activity and owns the asset as a result of having previous incurred actual[10] capital expenditure on it, the person is treated as having incurred "notional expenditure" on the provision of that asset for the purposes of the qualifying activity. Broadly speaking, the value of the notional expenditure is the market value of the asset at the date it is brought into use for a qualifying activity or, if less, the actual expenditure incurred.

16. The capital allowances available under Part 2 are annual investment allowances (s51A), first-year allowances (s52), writing down allowances ("**WDA**") and balancing allowances (s55).

17. The particular focus of the present appeal concerns the legislation which provides for balancing charges in circumstances where a taxpayer disposes of plant and machinery for a consideration which exceeds the written-down value of the asset for capital allowances purposes.

18. Section 53(1) provides for the pooling of QE for the purposes of determining a person's entitlement to WDAs and subsequently for the purposes of determining entitlement/liability to balancing allowances/balancing charges. By virtue of sections 54 and 127, where the taxpayer concerned wants to claim allowances for QE on the provision of a ship, the expenditure is usually[11] allocated to a pool comprising only the ship itself known as a single ship pool.

19. Section 55 provides:

> (1) Whether a person is entitled to a writing-down allowance or a balancing allowance, or liable to a balancing charge, for a chargeable period is determined separately for each pool of qualifying expenditure and depends on:
>
> > (a) the available qualifying expenditure in that pool for that period ("AQE"), and
> >
> > (b) the total of any disposable receipts to be brought into account in that pool for that period ("TDR").
>
> (2) If AQE exceeds TDR, the person is entitled to a writing-down allowance or a balancing allowance for the period.

[9] Although not relevant for the purposes of the present appeal the requirement to own the plant and machinery as a consequence of incurring the expenditure includes full legal ownership and the rights under finance leases; s11 also provides for qualifying expenditure to arise in limited situations not giving rise to ownership including in respect of fixtures to land where legal ownership will be with the land owner not necessarily the party making the expenditure.

[10] s13(1)(b) CAA.

[11] Subject to an election under s129 CAA.

> (3) If TDR exceeds AQE, the person is liable to a balancing charge for the period.
>
> …

20. During the period relevant to the appeal, section 56(1) provided that the rate of WDA was 25% to 2008 and 20% thereafter (it has since been reduced to 18%) such rate being applied for the chargeable period to the amount by which available qualifying expenditure ("**AQE**") (adopting the same definition as in s55) exceeds total disposal receipts ("**TDR**"). Pursuant to s56(6) a person is liable to a balancing charge where, and to the extent that, TDR exceeds AQE.

21. The amount of AQE in any period is determined for each asset pool, pursuant to s57(1), as the total of QE allocated to the pool in that period plus any unrelieved qualifying expenditure ("**UQE**") carried forward from a previous chargeable period. Section 59 defines that UQE is the excess of AQE over TDR in a period, minus the amount of WDAs for the period.

22. Sections 60 – 62 provide the process by reference to which, in respect of any particular asset pool, TDR is determined. In summary, these provisions require that in respect of a chargeable period, where a disposal event occurs (including where a person ceases to own plant and machinery, or begins using it for a purpose other than a qualifying activity) within an asset pool the disposal value, up to its value at entry into the pool, is to be brought into account.

23. Section 64 (1) provides:

> A person is not required to bring a disposal value into account in a pool for a chargeable period in respect of plant or machinery if none of the qualifying expenditure is or has been taken into account in a claim in determining the person's available qualifying expenditure in the pool for that or any previous chargeable period.

24. Section 127 provides that QE incurred on the provision of a ship for the purposes of a qualifying activity must be allocated to a single ship pool "if allocated to a pool".

Sch 22

25. As indicated in paragraphs 3 to 9 above Sch 22 provides the legislative framework for the operation of the TTR.

26. The provisions of the TTR dealing with capital allowances are principally contained in Part IX of Sch 22. This part is entitled "The Ring Fence: Capital Allowances: General".

27. At the material time (and post the amendments in 2005) paragraph 68 provides:

> Introduction
>
> (1) This Part of this Schedule makes provision about capital allowances where a company enters, leaves or is subject to tonnage tax.
>
> (2) The general scheme of this Part of this Schedule is that:
>
> > (a) entry of a company into tonnage tax does not of itself give rise to any balancing charges or balancing allowances.
> >
> > (b) a company subject to tonnage tax is not entitled to capital allowances in respect of expenditure incurred for the purposes of its tonnage tax trade, whether before or after its entry into tonnage tax, and
> >
> > (c) on leaving tonnage tax:
> >
> > > (i) a company is treated as having incurred qualifying expenditure on its tonnage tax plant and machinery assets of an amount equal to the lower of cost and market value, where it leaves tonnage tax

on expiry of an election or on the taking effect of a withdrawal notice[12], but

(ii) otherwise, a company is put broadly in the position it would have been in if it had never been subject to tonnage tax.

(3) A company's tonnage tax trade is not a qualifying activity for the purposes of determining the company's entitlement to capital allowances.

28. Paragraphs 69 – 72 deal with the capital allowance position when a company enters TTR. In summary, on entry into the TTR any UQE[13] attributable to plant and machinery that is to be used wholly for the purposes of the company's tonnage tax trade is taken into a single pool known as the tonnage tax pool. Where plant and machinery is partly so used, the relevant provisions[14] of the CAA apply such that the use for tonnage tax purposes is treated as a non-qualifying activity. These paragraphs also provide for the situations where: qualifying ships are acquired within 6 months before entry into tonnage tax and disposed of within 12 months; and where a balancing charge was deferred and set against new expenditure incurred within six years pursuant to ss135 - 156 of the CAA.

29. Paragraphs 73 – 81 deal with the capital allowances provisions during a period when a company is within tonnage tax. Again in high level summary the provisions deal with situations in which: new expenditure is incurred partly for tonnage tax purposes; an asset begins to be used for a tonnage tax trade; change of use; disposals; deferment of balancing charges; and surrender of UQE. The detail of the operation of these provisions is addressed in the discussion below.

30. Paragraph 85 deals with the capital allowance consequences, in respect of plant and machinery, on exit from tonnage tax and provides:

(1) If a company leaves tonnage tax:

(a) the amount of qualifying expenditure under Part 2 of the Capital Allowances Act 2001 (plant and machinery allowances) (plant and machinery), and

(b) the pools to which such expenditure is to be allocated for the purposes of that Part,

shall be determined under this paragraph.

(1A) Sub-paragraph (1C) applies where the company leaves tonnage tax:

(a) on the expiry of a tonnage tax election, or

(b) on a tonnage tax election ceasing to be in force under paragraph 13(2A) (taking effect of withdrawal notice under paragraph 15A).

(1B) In any other case, sub-paragraph (2) applies.

(1C) Where this sub-paragraph applies, the amount of qualifying expenditure in respect of each asset used by the company for the purposes of its tonnage tax activities and held by the company when it leaves tonnage tax shall be taken to be:

(a) the market value of the asset at the time the company leaves tonnage tax, or

[12] Following the amendments made in 2005 the statute provided that those impacted by the changes were provided with a limited period in which to withdraw from TTR. These withdrawal provisions are not relevant in the present appeal.
[13] By virtue of paragraph 69(2) UQE for the purposes of Sch 22 has the same meaning as UQE under the CAA.
[14] ss61(1)(e), 206(3) and 207.

> (b) if less, the amount of expenditure incurred on the provision of the asset that would have been qualifying expenditure if the company had not been subject to tonnage tax.
>
> (2) Where this sub-paragraph applies, for each asset used by the company for the purposes of its tonnage tax activities and held by the company when it leaves tonnage tax there shall be determined:
>
> (a) the amount of expenditure incurred on the provision of the asset that would have been qualifying expenditure if the company had not been subject to tonnage tax, and
>
> (b) the written down value of that amount by reference to the period since the expenditure was incurred.
>
> (3) The Inland Revenue shall make provision by regulations as to the basis on which the writing down is to be done.
>
> The regulations may make different provision for different descriptions of asset.

31. The provisions of paragraph 85(1A) – (1C) were introduced in 2005. Prior to that date the provisions on exit were not differentiated on the basis of the rationale for leaving the TTR.

32. Paragraph 87 provides:

> (1) Where any provisions of this Part of this Schedule states that a person is not entitled to capital allowances in respect of expenditure on plant or machinery:
>
> (a) …
>
> (b) the expenditure shall be disregarded for the purposes of calculating the person's entitlement to a writing-down allowance or balancing allowance or liability to a balancing charge.
>
> (2) …

33. Paragraph 88 provides the interpretation provisions:

> (1) In this Part of this Schedule:
>
> "capital allowance" means any allowance under the Capital Allowances Act 2001;
>
> "qualifying activity" means any activity in respect of which a person may be entitled to a capital allowance;
>
> "qualifying expenditure" means expenditure in respect of which a person is or may be entitled to a capital allowance.
>
> (2) In this Part of this Schedule any reference to pooling or to single asset pools, class pools or the main pool shall be construed in accordance with sections 53 and 54 of the Capital Allowances Act 2001.
>
> (4) Other expressions relating to capital allowances have the same meaning in this Part of this Schedule as in the Capital Allowances Act 2001.

34. The Tribunal notes that the term "qualifying expenditure" is used in Part IX Sch 22, so far as plant and machinery is concerned, only in paragraphs 68 (introduction), 77 (disposals within tonnage tax), 85 (exit: plant and machinery).

Tonnage Tax Regulations 2000 SI 2000/2303 ("the TT Regs")

35. Regulation 4 of the TT Regs is also relevant and provides:

Plant and machinery other than expensive motor cars and long life assets – writing-down basis

(1) This regulation applies to any asset mentioned in paragraph 85(2) of Schedule 22, where the provisions of Part II of the 1990 Act would have applied to the asset on the footing that the company has not been subject to tonnage tax ("the tax condition"), other than:

(a) a motor car, … or

(b) a long-life asset, ..

(2) The written down value of the paragraph 85(2)(a) amount for the asset shall be determined by multiplying that amount by the percentage given by the table in paragraph (3).

(3) That table is as follows:

Length of qualifying holding period for the asset	Percentage of the paragraph 85(2)(a) amount which is qualifying expenditure under Part II of the 1990 Act
Less than or equal to 1 year	75
…	
5 years and one day to 6 years	15
…	

(4) References in this regulation and regulations 5 and 6 to the qualifying holding period for an asset are references the period between:

(a) the date on which the expenditure represented by the paragraph 85(2)(a) amount, or the part thereof, was incurred, and

(b) the date on which the company leaves tonnage tax.

36. The provisions of Reg 4 TTR Regs are as originally enacted in 2000. The percentage calculations broadly reflect WDAs at 25% and have not been amended to reflect the lower percentage allowances that since 2009 and subsequently have been available.

APPROACH TO INTERPRETING THE STATUTORY PROVISIONS

37. As indicated in paragraph 3 above, the provisions set out above are provisions of domestic law and provide a formulaic statutory framework for relief which constitutes a scheme of approved state aid.

UT428's submissions

38. UT428 invited the Tribunal to take a traditional or orthodox approach to the interpretation of the statutory provisions relevant to determining whether it was subject to a balancing charge in accordance with, in particular, paragraph 85 and s55. By reference to which, it was contended, the Tribunal should have regard to the following applicable principles:

(1) The function of the Tribunal is to determine the meaning of the words used in the statutory provisions and not a more wide ranging understanding of the intention of Parliament in enacting the provisions.

(2) The context and mischief at which the statute is aimed are factors which must be taken into account but they do not require the Tribunal to ignore the plain meaning of the word used.

(3) Explanatory notes ("**ENs**") may cast light on the objective or context of a statute and the mischief at which it is aimed but the Tribunal should not treat the wishes and desires of the Government as expressed in ENs about the scope of the statutory language as reflecting the will of Parliament. The aims of the Government in respect of the meaning of clauses as revealed in ENs cannot be attributed to Parliament. The object is to see what is the intention expressed by the words enacted.

(4) When construing, in particular, the provisions of paragraph 85 the Tribunal was entitled to have regard and use, as an aid of construction, the statutory language of the TT Regs; such regulations having been enacted roughly contemporaneously with, and forming part of, the overall code of the TTR[15].

HMRC's submissions

39. HMRC contended that the Tribunal was required to adopt a more purposive interpretation of the legislation, relying heavily on the fact that tonnage tax is an approved state aid. In this regard, HMRC relied on a number of EU materials and the ENs introducing and subsequently amending Sch 22.

40. HMRC invited the Tribunal to respect the nature of tonnage tax as a hugely generous relief the scope of which should not be extended in the manner which, HMRC contended, would result if the legislative interpretation advanced on behalf of UT428 were adopted.

41. HMRC referred the Tribunal to the judgment in *Western Ferries v HMRC* [2011] UKFTT 243. That case concerned whether that taxpayer's ships, which were certified for occasional navigation at sea and operated across the estuary of the Clyde River, were qualifying ships for the purposes of tonnage tax. In the judgment, when considering the approach to construction, the tribunal undertakes a review of the EU context and approval of tonnage tax as approved state aid. The tribunal expressed the view that:

> "163. … the European dimension and what may be said to be the underlying purpose of the introduction of the tonnage tax regime … cannot be ignored; they must be given consideration and due weight within the overall application of the principles of statutory interpretation. It is true that Schedule 22 is not transposing an EU Directive or Regulation. Nevertheless, it is plain that the intention of Parliament must have been to enact a provision which was consistent with the Commission's views on tonnage tax, which did not fall foul of its Treaty obligations in relation to State aid …
>
> …
>
> 181. … These authorities leave us in no doubt that it is legitimate to have regard to the "State Aid" background to the enactment of schedule 22 to the FA 2000 in order properly to construe the relevant provisions purposively, viewing the applicable facts realistically.
>
> 182. The authorities demonstrate the potency of the law of the European Union where it forms part of the landscape or context of a national legislative provision, whether in the foreground for example in the form of a Directive or in the background in the form of Treaty obligations and related guidelines or similar material."

[15] UT428 referenced in support the following judgments in this regard: *Deposit Protection Board v Dalia* [1994] 2 AC 367, *R (ex p Mehari) v Secretary of State for the Home Department* [199] QB 474 and *Hanlon v The Law Society* [1981] AC 124.

42. By reference to *Western Ferries* HMRC contended that the Tribunal should have regard to the EU context of the TTR, taking account of relevant EU material concerning the evaluation of EU wide proposals for the introduction of relief for the EU shipping sector and the subsequent review of it. The Tribunal was invited to treat the TTR as a regime which relieves those within it from substantial fiscal liabilities. HMRC contended that the approach to be adopted to interpretation was therefore one which limited the tax relief available to UT428 only to tonnage tax, ensuring that the charge to tonnage tax represented the "ceiling" of relief available to shipping companies as articulated by the Commission in its communication "C(2004) 43 – Community Guidelines on State Aid to maritime transport".

43. As is more specifically set out below, HMRC contend that paragraph 85 is a deeming provision creating an hypothesised world where a company exiting the TTR is then deemed to have been in a world in which it had claimed capital allowances. Relying on the court of appeal judgment in *Marshall v Kerr* [1993] STC 360 (at 365 – 6) HMRC invited the Tribunal to identify, by reference to the scheme of the TTR, and as explained in the EN for paragraph 85, the purpose of this statutory fiction.

44. HMRC's case also invited the Tribunal to use the ENs as evidence of the intention of Parliament when enacting the relevant legislative provisions. They relied on the House of Lords judgment in *R (Westminster City Council) v National Asylum Support Service* [2002] UKHL 38.

Approach to be adopted

45. As a consequence of HMRC's contention that the Tribunal's approach to interpretation should be (1) "influenced by the need for compatibility with EU law" and, (2) consistent with the approach taken in *Western Ferries* such that the Tribunal was obliged to interpret the relevant provisions in such a way as to avoid a breach of the UK's Treaty obligations on state aid, the Tribunal invited additional submissions on the question of whether a more wide ranging or conforming interpretation must be adopted.

46. A conforming interpretation is required where legislation is subject to directly applicable or directly effective provisions of EU law or where s3(1) Human Rights Act 1998 applies. In such circumstances, it is the obligation of the UK courts (including this Tribunal) to construe domestic law, so far as possible, to ensure EU or ECHR compliance. Such an approach provides for much greater latitude on the part of the judiciary than in a purely domestic context to read words into, or strike through, statutory language in order to ensure compliance with the relevant EU/ECHR obligations. Essentially, provided that the "violence" done through reading in or out "goes with the grain" of the legislation such "violence" is permitted (see the approach adopted by the Court of Appeal in *HMRC v IDT* [2006] EWCA Civ 29 when interpreting provisions of the Value Added Tax Act 1994 implementing provisions of the (then) Sixth VAT Directive 77/388 EC and by the Supreme Court in *Ghaidan v Godin-Mendoza* [2004] AC 557 when interpreting s3(1) Human Rights Act 1998).

47. However, following these additional submissions it was apparent that the parties were agreed that a conforming interpretation was inappropriate when interpreting the legislative provisions in dispute in the present appeal. They agreed that:

(1) there was no EU legislative provision to which the TTR was required to conform;

(2) the assessment of compatibility of aid measures falls within the exclusive competence of the Commission and subject to review by the Courts of the European Union; and

(3) should the Tribunal determine that the UT428's interpretation of paragraph 85 prevails the absence of a balancing charge would <u>not</u> amount to illegal state aid.

48. On the basis of all the submissions the Tribunal determines that it is required simply to interpret the intention of Parliament as evidenced by the words of the statutory provisions themselves and cognisant of the statutory context in which those words are used i.e. as part of the TTR.

49. Paragraphs 50 to 54 below address some of the individual matters raised by the parties regarding the approach to be adopted when interpreting the relevant statutory provisions and the Tribunal's decision in respect of them

50. Whether or not paragraph 85 is a deeming provision with the projected hypothesis for which HMRC assert, is fundamentally a question of determining, from the statutory language used, how the TTR and CAA regimes work together. As part of that process it is appropriate to consider the grammatical and ordinary sense of the words used consistently with the policy of Sch 22, as evident from the Schedule itself, unless doing so results in an absurdity (see *Marshall v Kerr* page 366 and *Jenks v Dickinson* [1997] STC 853 at 878 e – g and 879 d).

51. When considering the relevance of the status of the TTR as approved state aid it is important to recognise that *Western Ferries* concerned the gateway conditions to TTR; thus the judgment of that tribunal that it should construe the provisions so as not to extend the scope of the TTR is clearly correct. However, the present appeal concerns the application of the detailed statutory provisions as to the operation of TTR. Whichever interpretation of those provisions is adopted by the Tribunal, as now accepted by both parties, the scope of the approved state aid permitted under TTR will not be "extended" or risk a breach of the UK's Treaty obligations. The status of TTR as approved state aid does not therefore drive a purposive construction.

52. The meaning of, in particular, paragraphs 68 and 85, and Regulation 4 TT Regs are not therefore influenced one way or the other by the EU context of TTR. Still less so the provisions of s55.

53. In any event, when interpreting the provisions of the TTR, it is necessary to consider the provisions of Sch 22 and the TT Regs, as together they govern the operation of the regime forming the overall code. By reference to the guidance of the courts, as set out in the case law identified in footnote 15 above, the Tribunal considers that the TT Regs inform, but do not determine, the interpretation of the Sch 22 provisions.

54. Finally, with regard to the role of ENs in *Westminster City Council v National Asylum Support Service* [2002] 1WLR 2956, Lord Steyn sets out the historical narrative for the introduction and purpose of ENs as notes "prepared by the Government department responsible for the legislation" with the "aim to explain the effect of the text and not to justify it" (paragraph 4). In determining EN's relevance to statutory interpretation Lord Steyn reinforces that the starting point will be the language used in the context in which it is so used with the consequence that to the extent that the ENs "cast light on the objective setting or contextual scene of the statute, and the mischief at which it is aimed, such materials are admissible aids to construction."

SUBSTANTIVE ISSUE IN THE APPEAL

UT428's submissions

Section 64 CAA submission

55. With regard to the operation of the CAA, UT428 made some general propositions:

(1) The purpose of the capital allowance regime is to allow some or all of the cost of capital items to be treated as expenses in calculating profits of a trade.

(2) There is no obligation on a taxpayer to claim capital allowances, but in order to make the deduction against profits, the capital allowances *must* be the subject of a claim[16].

(3) A claim to capital allowances must be made on a tax return.

(4) The rules on allocation to asset pools set out in sections 53, 54 and 58 are neither mandatory nor automatic, but are entirely dependent upon a claim to capital allowances being made. Once the claim is made QE is allocated to an appropriate pool.

(5) The effect of WDAs is simply to spread the cost of the asset over the notional life of the asset, thus reflecting depreciation of that asset and so limiting in each year the deduction allowed against profit.

(6) The role of the provisions concerning balancing charges and balancing allowances when an asset is sold is to compare the deduction given by reference to the notional diminution in value of the asset against the actual reduction in value on disposal and effectively equate the deduction to the expense.

56. Central to UT428's case on s64 is the submission that given the scheme of capital allowances and the purpose of a balancing charge, it is logical that where no claim has been made for a capital allowance, there is no requirement to bring any disposal value into account. On the basis that if this were not the case, then a balancing charge would be recapturing allowances that were never given and would amount to a freestanding tax.

57. UT428 was clear that it had never been allocated to an asset pool and had not claimed capital allowances in respect of the Ship. The same is the case for all the relevant owners of the Ship in the Tonnage Tax Group. HMRC accepted there had been no claim for allowances outside the TTR.

58. On the facts, and by reference to s64, UT428 contends that there was no statutory basis for bringing the disposal value of the Ship into the calculation of a balancing charge under s55, with the consequence that no charge can possibly be brought into account.

59. If the Tribunal accepted that argument, UT428 contended that concluded the appeal in its favour.

Effect of paragraph 68(2)(c) Sch 22

60. UT428's second argument was founded on the terms of paragraph 68(2)(c)(ii) and the requirement that on leaving the TTR (except on the expiry of the tonnage tax election or in consequence of a withdrawal notice) the company be "put *broadly* in the position it would have been in if it had never been subject to tonnage tax".

61. It was contended that if UT428 had never been in the TTR it would have had the free choice of whether and, if so when, to allocate the QE incurred on the acquisition of the Ship to a single ship pool and, if so allocated whether to claim WDAs. Only if claims had been made would the provisions of s55 have applied on disposal of the Ship. A balancing charge would have been due, so it was asserted, only if UT428 had claimed the allowances and the disposal value was greater than the AQE as at the date of disposal.

62. UT428 strongly asserted that key to there being a balancing charge is that its rationale is to recapture excessive WDAs previously claimed. A balancing charge returns the claimant to a neutral position where the expense/deduction allowed over the period from when the QE was

[16] This position is confirmed in the case of *Elliss v BP Oil Northern Ireland Refinery Ltd* 59 TC 474 and was not disputed by HMRC

allocated to an appropriate pool to the date of disposal were equated to the actual diminution in value of the asset over that period.

63. As UT428 was within the TTR, it was precluded from claiming any WDAs with the consequence that there is nothing to adjust. Therefore, to require a balancing charge would bring about an unwarranted and unjustified charge to tax and not the neutrality intended. UT428 contends that, rather than neutrality, the imposition of a balancing charge on exit from the TTR is to bring into charge a purely notional amount of profit in addition to the charge to corporation tax on the tonnage tax profits. Essentially, it was submitted that a balancing charge in these circumstances would lead to double taxation. This position is, UT428 assert, particularly draconian in a situation in which the company was loss making and therefore paid corporation tax under the TTR it would not have paid under the conventional basis of taxation and in the context of the costs of compliance with TTR including the costs of strategic management being required to be in the UK and the training requirements.

64. Accordingly, it was contended that the filing position adopted by UT428 (in which no balancing charge was brought into account) was in accordance with paragraph 68(2)(c)(ii) and UT428 was "broadly" in the same position as if had it never been in the TTR.

Application of paragraph 85 Sch 22

65. As set out at [30] above paragraph 85(1) provides that if a company leaves the TTR in the circumstances of the present case the amount of QE and the pools to which it is allocated are determined in accordance with paragraph 85(2). UT428 contends that having so determined the value for QE such QE is then available to be allocated to an asset pool and, at the discretion of the company, then subject to a claim to capital allowances.

66. UT428 contends that the purpose of paragraph 85 is to determine a single figure of QE for CAA purposes by way of a two-step process: (1) to determine to acquisition cost of the asset and (2) write that cost down by reference to the period since the expenditure was incurred. The basis of the second step of that process is as set out in paragraph 85(3), which, by reference to Reg 4 of the TT Regs, requires that the written down value of the acquisition cost identified at paragraph 85(2)(a) be determined by applying the designated percentage identified in the table at [35] (that percentage reflecting the qualifying holding period for the asset - as per the descriptor in the table itself).

67. Applying this analysis to the facts of the present appeal UT428 contends:

(1) Paragraph 85(2)(a) requires identification of UT428's acquisition cost of the Ship ($25,320,135).

(2) Paragraph 85(2)(b) then requires the figure so identified to be written down by reference to the relevant entry in the table in Reg 4 TT Regs i.e. 15%.

(3) These two steps give a figure of QE of $3,798,020.25.

(4) This figure for QE is then the figure available to UT428 for the purposes of the provisions of the CAA.

(5) Had UT428 determined to make a claim for capital allowances having left the Tonnage Tax Group (bearing in mind it retained the legal ownership of the Ship but was not entitled to be part of the Tonnage Tax Group because the ship was subject to the Bare Boat Charter) it could have allocated that sum of QE to a single ship pool (in accordance with ss53, 54 and 127) and claimed WDAs whilst it continued its ownership.

(6) Had the Ship then been the subject of a disposal prior to a claim for WDAs being made in accordance with s57 the AQE would be the QE allocated to the pool ($3,798,020.25) plus UQE (in this case nil as the Ship is allocated to an single ship pool)

resulting in AQE being $3,798,020.25. The TDR is restricted to QE by s62 and as TDR equals AQE neither a balancing charge nor a balancing allowance arises.

68. UT428 submits that there is nothing surprising about this result, as UT428 had not, through the life of the asset, claimed any WDAs, it had not therefore received any deduction against income. Put simply there is nothing to adjust by way of balancing charge or allowance.

69. It is also contended that such an interpretation is entirely consistent with the terms of paragraph 87, which provides that expenditure incurred for the purposes of a tonnage tax trade is disregarded for the purposes of calculating WDAs, balancing allowances and charges. In UT428's view, the original cost of the Ship was incurred for the purposes of UT428's tonnage tax trade and must therefore disregarded for the purposes of calculating any WDAs or a balancing charge.

70. The position taken, it is also said, is consistent with the general scheme of capital allowances. As the purpose of a balancing charge is to recapture allowances given for an assumed capital expense which, by reference to the disposal value achieved, was over generous, where no capital expense has been assumed or given there can be no reason for it to be recouped.

HMRC's submissions

71. HMRC contend that, the provisions of paragraphs 68(2)(c)(ii) and 85 are intended to put UT428 in broadly the position it would have been had it not been subject to tonnage tax. As a consequence, those provisions require the construction of a deemed state of affairs: one which determines QE, the pool to which such QE is allocated and the amount by which that QE is written down as at the date of leaving tonnage tax. HMRC contend that the figure arising as a consequence of the exercise required is a figure of AQE and not QE. With the consequence that a balancing charge is due under s55.

72. Their analysis of paragraph 85, in the present context, is as follows:

(1) Paragraph 85(2)(a) determines UT428's QE as the amount that would have been QE had UT428 not been subject to tonnage tax: $25,320,135

(2) Paragraph 85(1)(b) requires, by its express language ("the pools to which such expenditure is to be allocated shall be given by this paragraph") that the QE be allocated to a single ship pool (as per ss 53 and 127).

(3) Paragraph 85(2)(b) and (3) determine the amount of AQE by reference to a written down value determined in accordance with the percentage given in Reg 4 TT Regs: $25,320,135 x 15% = $3,798,020.25. This sum being "broadly equivalent to the level of write-down that would result from a company outside tonnage tax claiming all normal allowances on the same expenditure over the same period" (as articulated by the EN for paragraph 85).

(4) Paragraph 85(3) clearly providing the vires for the regulations that shall be made "as to the basis on which the writing down is to be done".

73. HMRC acknowledge that paragraph 85 does not expressly state that for these purposes the tonnage tax trade shall be regarded as a qualifying activity. Rather, they contend that it is implicit in the use of 'qualifying expenditure' and follows from the disapplication of paragraph 68(3) by paragraph 68(2)(c)(ii). The effect of these provisions, say HMRC, is that a company that leaves for reasons other than expiry or waiver, is treated as if it was never within the TTR but claimed an assumed level of WDAs and that the provisions of s13 are expressly overridden.

74. On this construction, HMRC contend that the figure identified in consequence of the application of paragraph 85 is the figure of AQE for all prospective capital allowance purposes: both WDAs and balancing charge/allowances.

75. HMRC emphasised that, without this construction, a company is effectively given a retrospective choice as to where to allocate QE to a pool for the period in which it was in fact subject to tonnage tax, such choice being exercised with the benefit of hindsight. This outcome, in HMRC's view, operates unfairly giving an additional financial benefit over and above that inherent within the TTR.

76. HMRC refer to the following ENs:

> CLAUSE 81 AND SCHEDULE 22 TONNAGE TAX
>
> SUMMARY
>
> Clause 81 and Schedule 22 provide for an operational new ring-fenced regime for shipping companies known as "tonnage tax". Under a 10-year election into this regime a shipping company would work out its taxable profits based on the tonnage of ships it operates, rather than by reference to its actual business results. This favourable new regime is being introduced to help deliver the Government's aim of encouraging the British shipping industry.
>
> …..
>
> Paragraph 85
>
> When a company leaves tonnage tax, it will once again wish to claim capital allowances on expenditure incurred on machinery and plant used for the purposes of its trade. Paragraph 85(1) says that the rules in paragraph 85 should be used to determine what proportion of the company's expenditure on assets held at the time of leaving the regime will qualify for future capital allowances and which capital allowance pools that expenditure should be placed in.
>
> Those rules are set out in paragraph 85(2) which looks at the company's machinery and plant held on exit from the regime on an asset by asset basis. The amount of qualifying expenditure is calculated by taking the amount of expenditure which would have qualified for capital allowances at the time the company acquired the asset and writing down that expenditure over the period between that time and the company's exit from tonnage tax.
>
> As provided for in paragraph 85(3), the Inland Revenue will issue Regulations setting out the basis upon which expenditure should be written down up to the date of the company's exit from tonnage tax. Those Regulations will be published in draft as soon as they are available. The Regulations will include separate tables of rates to be used for normal machinery and plant (including ships) and for long life assets. The rates set will be broadly equivalent to the level of write-down that would result from a company outside tonnage tax claiming all normal allowances on the same expenditure over the same period of time.

77. Critically, HMRC contend that the explanatory notes evidence that tonnage tax is in part an advance of alternative relief to capital allowances for the period that the company is subject to the TTR.

78. HMRC further contended that the EN confirms that the rates used in the table in Regulation 4 mathematically gave the equivalent result as the situation which would result were it the case that the company had never been within the TTR and had claimed all the normal allowances on the same expenditure over the same period of time.

79. HMRC highlight the contrast between the exit regime applicable under paragraph 68(1)(c)(i) for companies which leave the TTR on the expiry of an election, or where, post 2005, they ceased to be eligible for the TTR and that under paragraph 68(1)(c)(ii) for all other leavers. For those who leave as envisaged under paragraph 68(1)(c)(i), QE is the lower of cost or market value of the asset on the date the company leaves the TTR. Such companies carry forward this value as AQE on which future capital allowances can be claimed, reducing the consequence and likelihood of a balancing charge. HMRC contend that it would be anomalous if UT428's interpretation were to prevail as those leaving the TTR early would, in many situations, be in a better position vis a vis capital allowances than those remaining in the TTR.

80. In support of this contention HMRC referred to the "Post Implementation Review of Tonnage Tax: a Report by the Inland Revenue and Department of Transport (December 2004)" which proposed changes to Sch 22 following the EU amendment to approval affecting, in particular, tugs thereby rendering a number of operators ineligible for the TTR. The Post Implementation Review expresses the Governmental view that:

> "52. The Government recognises that there needs to be fair and appropriate arrangements for operators within tonnage tax that will be affected by the new rules … the Government will legislate to ensure that those parts of the existing rules imposing a tax penalty for early exit from tonnage tax (i.e. before the expiry of a tonnage tax election) do not apply. Changes to the exit rules are set out in further detail below.
>
> …
>
> 61. In order to ensure that any company choosing to withdraw from tonnage can do so without incurring a tax penalty, the Government will also amend the rules relating to the calculation of capital allowance pools for plant and machinery assets after exit from the regime. At present these are designed to put a company in the same position that it would have been in if it had never been in tonnage tax. New rules will ensure that a company leaving tonnage tax, either on the expiry of its current election, or after giving a withdrawal notice, can do so on a basis that means it will not incur and immediate liability to deferred taxation on plant and machinery (including ships) used in tis tonnage tax trade.

81. HMRC contend that the difference between paragraphs 68(1)(c)(i) and (ii) is, in essence, that a leaver falling within (i) is entitled to take the current value of the asset as AQE whereas under (ii) an historic state of affairs is recreated assuming that the asset is one that had been the subject of a capital allowances claim and thereby duly written down by reference to the percentage in Reg 4.

82. By reference to the language of paragraphs 68, 85 and Reg 4, HMRC contend that the only coherent interpretation is that the resulting figure is the figure of AQE for the purposes of the s55 CAA calculation. With the consequence that the s62 CCA cap would apply only if the disposal value in fact exceeded the QE determined by reference to acquisition cost i.e. the figure identified in paragraph 85(2)(a).

83. By their statement of case, HMRC prayed in aid paragraph 86 concerning industrial buildings allowances ("**IBA**") contending that the language of that provision supported their submission on paragraph 85 as both provisions attributed a deemed history of claiming allowances to a company leaving the TTR. At the hearing HMRC specifically distanced their submissions from any comparison of paragraph 86.

84. HMRC contend that paragraph 87(1)(b) has no application as, having left the TTR, UT428 is deemed to be within the capital allowances regime.

85. It is further contended that, as the purpose of s64 is to avoid the requirement to bring a disposal value into account where a person has chosen not to pool relevant QE its provisions are inapplicable in a situation in which paragraph 85(1)(b) requires QE identified in paragraph 85(1)(a) to be pooled.

UT428's reply

86. UT428 is clear in its submission that the present case turns on the proper interpretation of paragraph 85 with paragraph 68 by reference to the statutory context.

87. In response to HMRC's position that the effect of paragraph 85 is that UT428 is deemed to have made a claim thus creating an alternative world hypothesis, UT428 contends that the language of paragraph 85 simply does not support HMRC. UT428 point to the use of the future tense in paragraph 85(1)(b): "is to be allocated", reflecting consistency with its own position that the claim to capital allowances may (or may not) be made. With paragraph 85(1)(a) and (2) determining the QE available to be allocated should the company so choose. It is contended that further support is derived from the language of s127 (single ship pools) which again refers to "if allocated to a pool".

88. UT428 contends that, where QE is allocated to a pool then, as evident from s53 CAA, the purpose of pooling expenditure is to determine a person's entitlement to capital allowances including balancing allowances and liability to balancing charges. Whilst there can be an entitlement to claim, unless the allowances are in fact claimed, no allowance is given (s3 CAA).

89. UT428 emphasise that HMRC's case relies on the "implicit" conclusion that the operation of paragraph 85 and Regulation 4 TT Regs involves the making of a claim for capital allowances in order to trigger the balancing charge. They contend that, as a matter of statutory construction, the reading in of what is implicit, is impermissible; particularly given the clarity of the statutory language used and the scheme of capital allowances which, in UT428's submission, are entirely predicated on there being an actual claim, made on a tax return. UT428 contends that the language of s64(5)(c) which references "in any other claim under this Part" references claims which, on the face of the CAA, do not need to be made in a tax return.

90. In this regard, UT428 referred to paragraph 86 concerning IBAs. Both pre and post amendment of paragraph 86 in 2008, its terms expressly deemed that all capital allowances that could have been made were deemed to have been made for the purposes of IBAs and, post 2008, explicitly references UQE rather than QE. However, UT428 otherwise considered paragraph 86 to provide no useful analogy as a consequence of the difference between the treatment for capital allowance purposes of plant and machinery and industrial buildings.

91. UT428 consistently repeated its position that HMRC's submission that the "output" of paragraph 85 as a figure for AQE and not for QE was simply inconsistent with the language used both in paragraph 85 itself and Reg 4 TT Regs, impermissibly requiring the Tribunal to read words into the statute producing an outcome which is at odds with the scheme and context both of capital allowances and tonnage tax.

92. To the extent relevant, UT428 considers that the EN for paragraph 85 relied upon by HMRC in fact supports its own position and not HMRC's.

93. With regard to HMRC's contention that the difference in treatment for those leaving the TTR on expiry of an election indicates that UT428's interpretation must be wrong (see [79] above), UT428 contend that the effect of paragraph 68(2)(c)(i) is to allow the prospective value of QE for those exiting on expiry to be the original acquisition cost or market value. In contrast to UT428, there is an order of magnitude difference in the prospective value for WDAs between a company leaving and falling within paragraph 68(2)(c)(i) and (ii). Using the figures for the Ship – the QE for prospective capital allowance purposes under (i) would have been

$23,250,000 and under (ii) was only $3,798,020.25. But in neither case does a balancing charge arise because in both cases TDR is equal to or capped at QE.

94. UT428 re-emphasised the acquisition cost of the Ship at the time of purchase is excluded from the definition of qualifying expenditure and that the provisions of paragraphs 68(2)(b) and 87(1)(b) require that expenditure incurred on the provision of a tonnage tax asset be disregarded for the purposes of calculating any liability to a balancing charge; reinforcing its submission that the statutory purpose and effect of paragraph 85 is to define QE at the point of exit for the purposes of re-entry into the capital allowances regime.

95. Underpinning the thrust of UT428's submissions is the neutrality which drives the need for either balancing charges or allowances. They both seek to match the allowance given against profits for the assumed accretion of capital expenditure over time to the actual diminution of value as it in fact turns out. Thus, if no allowance is made for such expenditure there can be no rebalancing of it required. A company within the TTR is not entitled to make any claim to capital allowances and therefore it will never be necessary for a balancing charge or allowance. However, as the company re-enters the normal basis for calculation of corporation tax, it is required to be given an hypothesised value for QE on which future claims to capital allowances may be made. This, UT428 say, is the only purpose of paragraph 85 which, on a prospective basis, and in accordance with paragraph 68(2)(c)(ii) puts the company in broadly the position it would have been had it never been in the TTR.

DISCUSSION

96. HMRC's case justifying the issue of the closure notice is predicated on a contention that the TTR is a ring fenced tax regime that replaces not only the basis on which revenue profits are calculated, but also imputes a deduction for capital expenditure. Put another way, because of the beneficial nature of the TTR, assets to which the capital allowance regime would apply (should the company choose to make a claim) are treated as if a capital allowances claim was de facto given as part of the TTR.

97. In order to determine whether or not that is the case the Tribunal considers that it is critical to understand the full extent of the relationship between the capital allowances regime and the TTR at every point at which they intersect with one another.

98. On that basis, in the paragraphs that follow, the Tribunal explores the operation of the capital allowances regime and the TTR by reference to the detailed operation of the statutory provisions and various permutations of an example loosely based on UT428's facts.

Application of CAA in the absence of a tonnage tax election

Allowances claimed

99. Assume a company (with a 31 December year end) purchases[17] a ship on 22 June 2004 for £14,000,000[18] and uses that ship for the purposes of a trade. Despite meeting the requirements of a qualifying company for the TTR, the company never makes an election into tonnage tax. The company sells the ship on 13 December 2010 for £12m.

100. On the facts of this example the company has (pursuant to s11(4)) incurred QE and is carrying on a qualifying activity (as defined in Chapter 2 of Part 2 CAA). Thus the company is entitled to claim capital allowances.

[17] Alternative rules apply to the lease of a ship but the facts of the present appeal concern the purchase of a ship. As this example is for comparison purposes only those additional rules are ignored.

[18] Dollar sterling exchange rate on 22 June 2004 was 1.8204 the Ship was purchased for $25,320,135

101. The company determines that it will claim capital allowances and allocates the ship to a single asset ship pool pursuant to ss 53, 54 and 127[19] with effect from 1 January 2005.

102. Having been so allocated, the company is entitled to claim WDAs in each chargeable period prior to disposal of the ship. The entitlement to WDAs is determined by applying a rate of 25% to the AQE for each chargeable period prior to 1 April 2008 and 20% thereafter[20].

103. The company claims the following WDAs:

The acquisition cost enters a single asset ship pool		14,000,000
At the end of the first chargeable period 25% WDA claimed	(3,500,000)	
AQE at the end of the first chargeable period (2005)		10,500,000
At the end of the second chargeable period 25% WDA claimed	(2,625,000)	
AQE at the end of the second chargeable period (2006)		7,875,000
At the end of the third chargeable period 25% WDA claimed	(1,968,750)	
AQE at the end of the third chargeable period (2007)		5,906,250
At the end of the fourth chargeable period 20% WDA claimed	(1,181,250)	
AQE at the end of the fourth chargeable period (2008)		4,725,000
At the end of the fifth chargeable period 20% WDA claimed	(945,000)	
AQE at the end of the fifth chargeable period (2009)		3,780,000

104. When the ship is sold in December 2010, section 132(2) requires that AQE is allocated to an appropriate non-ship pool and the disposal value for the ship is then brought into account for the purposes of calculating any balancing charge or allowance in the non-ship pool. The single ship pool comes to an end with no liability to a balancing charge. The balancing charge, if any, is determined by reference to the formula in s55. For the purposes of this example assuming there are no other assets in the main pool, the balancing charge is calculated as:

AQE transferred to non-ship pool	3,780,000
TDR = disposal value	12,000,000
Balancing charge excess of TDR over AQE	8,220,000

105. The balancing charge is necessary because the relief against profits allowed in respect of the capital expenditure through capital allowances exceeds the expense in fact incurred.

[19] The company does not make a s129 CAA election

[20] Post 2011 ships are treated as long life assets and subject to lower rates of WDA. Prior to 2011 ships were grandfathered out of the long life asset regime by s90 CAA

106. If the example is altered and the sale price of the asset were assumed to be £14,600,000 the balancing charge would be calculated as:

AQE transferred to non-ship pool	3,780,000
TDR = disposal value capped at QE	14,000,000
Balancing charge excess of TDR over AQE	10,220,000

107. Again, a balancing charge is necessary because the relief against profits allowed in respect of the capital expenditure through capital allowances exceeds the expense in fact incurred. TDR is capped at QE because capital allowances given will never exceed QE. The gain, in this example £600,000, on the sale of the ship will be taxed as a chargeable gain.

Deferral of allowances

108. Pursuant to the provisions of s3 and s59(2)(b), the claim to WDAs can be deferred such that in any chargeable period the company may simply choose not to claim the WDAs to which it is entitled. In which case, the UQE at the end of the chargeable period of deferral will be the same as the AQE at the start.

109. Modifying the above example:

The acquisition cost enters a single asset ship pool		14,000,000
At the end of the first chargeable period 25% WDA claimed	(3,500,000)	
AQE at the end of the first chargeable period (2005)		10,500,000
At the end of the second chargeable period no WDA claimed	nil	
AQE at the end of the second chargeable period (2006)		10,500,000
At the end of the third chargeable period 25% WDA claimed	(2,625,000)	
AQE at the end of the third chargeable period (2007)		7,875,000
At the end of the fourth chargeable period 20% WDA claimed	(1,575,000)	
AQE at the end of the fourth chargeable period (2008)		6,300,000
At the end of the fifth chargeable period no WDA claimed	nil	
AQE at the end of the fifth chargeable period (2009)		6,300,000

110. In this example, the balancing charge arising on an assumed selling price of £12,000,000 is calculated as at [104] as the excess of TDR over AQE, giving a balancing charge of £5,700,000. For a selling price of £14,600,000 the calculation is as at [106]: AQE – disposal value capped at QE giving a balancing charge of £7,700,000 (with the gain being prima facie subject to a charge to tax as a chargeable gain).

Allowances not claimed

111. If, pursuant to s3 the company never claims any capital allowances then, by virtue of s64(1) where no QE has been taken into account for the purposes of claiming allowances, the disposal value of the assets in question are not brought into account with the consequence that no balancing charge can arise. This reflects the somewhat obvious position that, as no relief is taken against profits in respect of the expenditure, there is no claw back required.

Allowances postponed

112. Pursuant to s130(2), a company with a ship allocated to a single asset ship pool (under s127) may, by notice to HMRC[21], apply for the postponement of all or part of the WDA. The effect of postponement is prescribed in s131 CAA which essentially allows for the postponed allowance to be carried forward and available in a later chargeable period. In relation to the continuing example these provisions operate as follows:

QE		14,000,000
Entitlement to WDA for first chargeable period at 25%	3,500,000	
Notice to postpone given for 50% WDA	1,750,000	
WDA for first chargeable period claimed		(1,750,000)
AQE[22] at the end of the first chargeable period (2005)		10,500,000
Postponed WDA carried forward	1,750,000	
Entitlement to WDA for second chargeable period at 25%	2,625,000	
Notice to postpone given for 100% WDA	2,625,000	
WDA for second chargeable period claimed		nil
AQE at end of the second chargeable period (2006)		7,875,000
Postponed WDA carried forward	4,375,000	
Entitlement to WDA for third chargeable period at 25%	1,968,750	
Claim to proportion of postponed WDAs	3,000,000	
WDA for third chargeable period claimed		(4,968,750)
AQE[23] at the end of the third chargeable period (2007)		5,906,250
Postponed WDA carried forward	1,375,000	
Entitlement to WDA for fourth chargeable period at 20%	1,181,250	
WDA for fourth chargeable period claimed		(1,181,250)
AQE at the end of the fourth chargeable period (2008)		4,725,000
Postponed WDA carried forward	1,375,000	
Entitlement to WDA for fifth chargeable period at 20%	945,000	
At the end of the fifth chargeable period 20% WDA claimed		(945,000)
AQE at the end of the fifth chargeable period (2009)		3,780,000
Postponed WDA carried forward		1,375,000

113. When the company sells the ship on 31 December 2010, the ship AQE is transferred to a non-ship pool and the disposal value brought into account. As a consequence of the provisions

[21] Provided to HMRC within 2 years of the end of the relevant chargeable period (s130(4))

[22] Section 131(1)(b) provides that the provisions of ss57 and 59 CAA apply as if no notice of postponement had been given

[23] Section 131(5) provides that the claiming of a postponed WDA is ignored for the purposes of s59 CAA

of s130, the balancing charge would be exactly the same as determined in [104] and [106] by reference to the differing assumed disposal values achieved.

114. By virtue of s131(3), the postponed WDAs can be taken against any balancing charge arising or against other shipping profits of the company (being profits from the same qualifying activity).

Allowances disclaimed

115. The right to postpone or defer the claiming of WDAs is to be distinguished from disclaiming the allowance under s56(5). Pursuant to that section, a person claiming WDAs may require the allowance to be reduced to a specified amount. The effect of doing so is as follows by reference to the same numerical example:

QE		14,000,000
Entitlement to WDA for first chargeable period at 25%	3,500,000	
Claim reduced to 50% WDA	1,750,000	
WDA for first chargeable period claimed		(1,750,000)
AQE at the end of the first chargeable period (2005)		12,250,000
Entitlement to WDA for second chargeable period at 25%	3,062,500	
Claim reduced to nil WDA	3,062,500	
WDA for second chargeable period claimed		nil
AQE at end of the second chargeable period (2006)		12,250,000
Entitlement to WDA for third chargeable period at 25%	3,062,500	
WDA for third chargeable period claimed		(3,062,500)
AQE at the end of the third chargeable period (2007)		9,187,500
Claim WDA for fourth chargeable period at 20%		(1,837,500)
AQE at the end of the fourth chargeable period (2008)		7,350,000
WDA for fifth chargeable period at 20% claimed		(1,470,000)
AQE at the end of the fifth chargeable period (2009)		5,880,000

116. In the case of reduced claims to WDAs, the balancing charge arising on the basis of a selling price of £12,000,000 is calculated as at [104] as excess of TDR over AQE giving a balancing charge of £6,120,000. For a selling price of £14,600,000 the calculation is as at [106]: the excess of TDR capped at QE over AQE giving a balancing charge of £8,120,000 (with the gain being prima facie subject to a charge to tax as a capital gain).

117. The provisions relating to disclaiming or reducing a claim to an allowance, and postponement can operate in parallel with a company reducing the claim and postponing the reduced claim.

Deferred balancing charge

118. The final example which needs to be considered is the impact of deferring a balancing charge.

119. Sections 135 – 156 provide the statutory framework pursuant to which a balancing charge incurred in relation to a ship may be deferred.

120. Essentially, where a balancing charge is incurred following a disposal event in relation to an old ship previously used for a qualifying activity, any balancing charge arising may be deferred, subject to certain conditions and limits[24], and subject to a claim[25] being made.

121. By virtue of s137, the claim to deferment is given effect by allocating the amount deferred, for the chargeable period in respect of which the claim is made, to the appropriate non-ship pool. Pursuant to s140 the company may, by notice, attribute all or part of an amount deferred to expenditure on new shipping.

122. The detailed rules regarding the circumstances in which deferment is possible, to what new expenditure and to what extent the deferred balancing charge can be attributed, are complex. The features of these provisions, relevant to the consideration of the Tribunal, are that 1) new expenditure may be incurred up to 6 years after the balancing charge arises and 2) pursuant to s143, the effect of allocation of the deferred amount is that such amount is brought into account as a disposal value in the single ship pool to which the new expenditure is allocated in the chargeable period in which the new expenditure is incurred.

123. In simple terms, the QE for the new ship is immediately reduced by the amount of the deferred balancing charge.

124. Again developing the example above, the shipping company has a balancing charge allocated to its general pool of £8,220,000 following the sale of the ship in the example at [103] (the old ship). If it is also assumed that the non-ship pool, to which the balancing charge is allocated has AQE of £1,000,000 when the balancing charge is allocated and a new ship is purchased in 2011 for £13,000,000 AQE for the new ship is determined as follows:

	Non-ship pool	Old Ship	New Ship
AQE in 2009	1,000,000	3,780,000	
Disposal of old ship		12,000,000	
Notional balancing charge arising		8,220,000	
Treated as a disposal	8,220,000		
Less deferred balancing charge	7,220,000		(7,220,000)
QE on new ship			13,000,000
AQE as at 2011 and available for WDAs			5,780,000

Tonnage tax

125. In order to understand the full extent of the relationship between the capital allowance regime and the TTR, the Tribunal invited the parties to submit a number of worked examples addressing the various permutations of interaction. The parties produced different permutations, some were agreed, others were not and neither party considered the full scope of the touch points between the capital allowance regime and the TTR. Set out below are the Tribunal's conclusions as to the taxing outcome of the various permutations by reference to the relevant statutory provisions. By reference to these permutations the operation of paragraph 85 can, in the Tribunal's view, be discerned.

Ship on which capital allowances have been claimed is held at point of entry into tonnage tax and ship is the subject of a disposal event whilst company is within the TTR

126. Normal capital allowance rules apply until entry into TTR.

[24] As per ss136 and 138 CAA

[25] Made on a Sch 18 FA 1998 return

127. It is the Tribunal's view that, by reference to the provisions of s61(1)(e) and paragraph 68(3), entry into tonnage tax constitutes a disposal event, as the assets used for the purposes of the tonnage tax trade cease to be used for a qualifying activity. However, by virtue of paragraph 68(2)(a), entry into tonnage tax does not, of itself, give rise to any balancing charges or balancing allowances. However, the Tribunal notes that paragraph 68(2)(a) does not deem that entry into tonnage tax does not meet the definition of a disposal event, rather it excludes the possibility that either a balancing charge or allowance will be made at that time.

128. By virtue of paragraph 69, the UQE of the ship (which is assumed to be used wholly for the purposes of a tonnage tax trade) is taken into the single tonnage tax pool on entry of the company into TTR. The company is not entitled to claim capital allowances on the tonnage tax pool (paragraph 68(2)(b)).

129. By virtue of paragraph 77, if a disposal event (as defined under Part 2 of the CAA[26]) occurs in respect of an asset within the tonnage tax pool, the company is required to set the disposal value of the asset against the UQE, determined as at entry into the TTR, in the tonnage tax pool. For the purposes of calculating the balancing charge, the disposal value is limited to the market value on entry into the TTR. Where the disposal value exceeds UQE, a balancing charge arises. Where UQE is equal to or exceeds disposal value, UQE is reduced or extinguished. There is no provision for a balancing allowance to be paid vis a vis an individual disposal event; however, it is implicit that to the extent that UQE remains in the tonnage tax pool it will be available as against any subsequent disposal from the pool. Otherwise it appears to the Tribunal that the benefit of the unused UQE will be lost[27].

130. However, where a balancing charge arises, paragraph 78 provides for a reduction to the charge by reference to the number of complete years the company has been subject to the TTR. There is a 15% reduction after one year rising in 15% increments to year 6 with 100% reduction at 7 years and beyond.

131. Paragraph 79 provides that any balancing charge which remains after the paragraph 78 adjustment is treated as arising in connection with a trade (other than the tonnage tax trade) and brought into account in the accounting period in which it arises. The charge may, however, be deferred pursuant to paragraph 80 (see below).

132. Continuing the example: assume that in 2004 a company acquires a ship for £14,000,000 and claims capital allowances for 3 chargeable periods. In 2007 the company enters the TTR and the ship has a market value of £11,200,000. The ship is then sold in 2010 under 3 alternative hypotheses: under hypothesis 1 it has a disposal value of £12,000,000, under hypothesis 2 its disposal value is £11,000,000 and under hypothesis 3 its disposal value is £5,800,000 (example table over page).

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[26] Essentially by reference to s61 CAA subject to the qualification contained in paragraph 77(2) (which requires that the definition of qualifying activity for the purposes of defining "disposal event" expressly includes tonnage tax trade as a qualifying activity).

[27] There is no provision equivalent to that in paragraph 79 Sch 22 which brings the outstanding allowance into account.

	Hypothesis 1	Hypothesis 3	Hypothesis 3
Costs at acquisition	14,000,000	14,000,000	14,000,000
AQE after year 3 = UQE	5,906,250	5,906,250	5,906,250
Market value on entry to tonnage tax	11,200,000	11,200,000	11,200,000
Receipt on disposal	12,000,000	11,000,000	5,800,000
Disposal value	11,200,000	11,000,000	5,800,000
UQE – disposal value	5,293,750	5,093,750	0
Reduction %	30%	30%	N/A
Balancing charge payable unless deferred	3,705,625	3,565,625	0

133. A variant on the above example arises when rather than being sold the asset ceases to be used for the purposes of the tonnage tax trade. In that scenario paragraph 75 provides that the provisions of s61(1)(e) apply but, for these purposes, treating use for purposes other than those of a qualifying activity (which would exclude tonnage tax trade) as use for purposes other than a tonnage tax trade. The normal capital allowances rules in s61(1)(e) and 61(2) apply to determine the disposal receipt as the market value on change of use. Paragraph 77 then applies as for any other disposal event to determine whether a balancing charge arises.

134. By reference to this example, precisely the same outcomes would arise as in [132] on the hypotheses that the market value, as at the date on which the change in use occurred, was £12,000,000, under hypothesis 1, £11,000,000 under hypothesis 2, and £5,800,000 under hypothesis 3 i.e. balancing charges of £3,705,625 for hypothesis 1, £3,565,625 for hypothesis 2 and nil for hypothesis 3.

135. These outcomes then need to be considered by reference to the general operation of the CAA.

136. As a tonnage tax trade is excluded from the definition of qualifying activity for capital allowance purposes[28], the ordinary operation of s61(1)(e) on entry into the TTR, would have required (by virtue of item 7 in the table set out in s61(2)) the market value of any plant and machinery previously within the capital allowance regime to be brought into account under the calculation required by s55. At that point a balancing charge or allowance would be determined by reference, in the case of a single ship pool, by comparing the market value of the ship to the UQE for the ship.

137. The effect of the provisions of paragraphs 69 and 77 effectively appears to only defer the crystallisation of any balancing charge which would have arisen on entry into the TTR until the point of actual disposal of the asset. The amount of the charge is capped at the difference between UQE on entry into the tonnage tax pool and the market value of the assets at that time. Any diminution in market value, determined by reference to the actual value achieved over the period of use for the tonnage tax trade accrues for the benefit of the company concerned. Paragraph 78 then provides further relief in respect of any balancing charge arising.

138. Such deferral appears to be broadly consistent with the terms of s60(3) which provides that if QE is allocated to a pool and more than one disposal event occurs a disposal value is

[28] By virtue of paragraph 68(3) Sch 22

only required to be brought into account in the pool in connection with the first event. Save in the case of a disposal value lower than UQE on the "second" disposal event, the mechanics of paragraph 77 give effect to a delay of the balancing charge that arose on the "first" disposal event i.e. entry into the TTR.

139. This conclusion is also consistent with the EN for paragraph 77 which provides:

> Under the existing system of capital allowances, where an item of machinery or plant is disposed of for more than its tax written down value, it may give rise to a balancing charge (a clawback of capital allowances given in excess of the actual depreciation suffered on the asset). At the time a company enters tonnage tax, it may have already claimed considerable amounts of capital allowances in respect of machinery or plant which is to be used for its tonnage tax business. These capital allowances may far exceed the actual amount of depreciation suffered on the asset up to the date of entry to the regime. It is not proposed to recover any such excess capital allowances by computing balancing charges upon the company's entry into tonnage tax. Instead balancing charges will only be computed in the event of a disposal of an asset after entry to the regime, as set out in paragraph 77.
>
> For this purpose paragraph 77(2) defines disposal as having the same meaning as for the normal capital allowances rules: for example it can include the permanent loss of the asset or its destruction as well as disposal by way of sale.
>
> Paragraph 77(3) limits the disposal value to be brought into account to the market value of the asset as at the date of the company's entry into tonnage tax. This limited disposal value is set against the remaining unrelieved expenditure in the tonnage tax pool. The market value will be known as it will have been calculated already under paragraph 69(3).
>
> The effect of paragraph 77(5) and (6) is that a balancing charge will arise to the extent that the limited disposal value exceeds the amount of unrelieved expenditure in the tonnage tax pool, although this may then be reduced by the operation of paragraph 78.

140. On the basis of this analysis, the Tribunal can see nothing in the operation of paragraphs 69, 75, 77 and 78 which deems the TTR as representing relief for capital expenditure against profits. Capital allowances are not given for the period in which the assets are within TTR and, in this scenario, the starting point for determining whether a balancing charge is due is to go back to the point of entry into TTR. Any balancing charge then being reduced, rather than increased, by reference to any diminution in value of the asset whilst used for a tonnage tax trade. Had it been the intention of Parliament to see the TTR as representing some form of capital allowance the Tribunal would have expected a deemed writing down of UQE in the tonnage tax pool over the life of the tonnage tax election akin to that contended for by HMRC in the present appeal.

Effect of the operation of paragraph 80 Sch 22

141. As indicated in [131] above, paragraph 80 provides for deferral of a balancing charge arising under paragraphs 77 – 79.

142. The scheme of balancing charge deferral, under paragraph 80, specifically excludes the deferral regime arising under s135 – 156, described in [118] – [124] above, and applies only to balancing charges arising under Sch 22. However, there may be an overlap between them.

143. Paragraph 80 provides that a balancing charge arising under paragraph 77, may be deferred thereby avoiding the charge to tax arising under paragraph 79 in the period of disposal. Deferral is subject to a claim being made under paragraph 80(1). In order to be deferred or

held over, the company must incur new expenditure on qualifying ships whilst within the TTR and within the period starting one year prior to disposal and running through to up to two years after the disposal. Although not abundantly clear, it appears that the balancing charge held over is the charge arising under paragraph 77 and before any adjustment under paragraph 78.

144. The effect of deferral may mean that the balancing charge never gives rise to a charge on taxable profits. Because the new expenditure is incurred during the operation of a tonnage tax election, the company is precluded from making a claim to capital allowances on the expenditure and the ship does not enter the tonnage tax pool. However, if the new ship is disposed of whilst the company is subject to the TTR, a relevant disposal of the new ship will crystallise the held over balancing charge (paragraph 80(3)). However, upon crystallisation the deferred balancing charge is then subject to the paragraph 78 adjustment.

145. Continuing again with the example at [132] and using hypothesis 1. The ship purchased in 2004 is sold in 2010, a new ship is purchased in 2009 for £13,000,000 and sold in 2011 for £13,000,000.

New qualifying ship purchased (2009)	13,000,000
New qualifying ship sold (2011)	13,000,000
Balancing charge due on old ship	5,293,750
Balancing charge arising applying reduction at 45%	2,911,563

Effect of paragraph 72 Sch 22

146. Paragraph 72 provides for the situation in which a company which has made a claim for deferral under ss135 – 156. Those provisions allow for the charge to be allocated to new expenditure incurred within 6 years after the claim to deferment has been made. It is, of course, therefore possible that, by the time the new expenditure is incurred, the company is subject to the TTR. Where new expenditure is incurred within the TTR, paragraph 72 provides that the balancing charge may only be deferred if the company was a qualifying company at the time the balancing charge was incurred i.e. qualified to be within tonnage tax, but not then subject to an election. Provided that condition is met, paragraph 72(3)(b) permits the expenditure on new shipping, albeit within the TTR, to be taken into account for the purposes of deferment under ss135 – 156 and that such expenditure shall be determined as if the company was not subject to tonnage tax.

147. For these purposes, assume a qualifying company purchases a ship in 2004 for £14,000,000. Capital allowances are claimed for 2005 (at 25%), before the ship is sold for £14,000,000. The company has no WDAs in the general pool to set against the balancing charge which is deferred in full. Therefore, on the sale, the company has a balancing charge of £3,500,000, which it defers. The company enters into the TTR on 2007 and purchases a ship costing £13,000,000, against which it seeks to allocate the deferred balancing charge.

	Old Ship	New Ship
Balancing charge on old ship	3,500,000	
Deferred balancing charge		(3,500,000)
QE on new ship		13,000,000
Deemed expenditure incurred		9,500,000

148. Neither Sch 22 nor CAA appear to address how the deferred balancing charge is to be recouped in the event that the new ship is sold whilst the company is within the TTR. Paragraph 74 provides that the new ship shall not be pooled into the tonnage tax pool and paragraph 68(3) precludes the pooling of the asset under the CAA. As set out at [155] below the sale and purchase of a capital asset whilst within the TTR will be excluded entirely from the capital allowances regime. However, if no account is taken of the disposal despite the deferred balancing charge there is no basis on which the deferred charge is recouped.

149. Paragraph 72(3)(b) provides that "the expenditure on new shipping that has to be taken into account for the purposes of those sections (i.e. ss135 – 156) shall be determined *as if the company was not subject to tonnage tax*" (emphasis added). However, ss135 – 156 do not deal with disposal events, having adjusted the value of QE by reference to the deferred balancing charge, any subsequent disposal will be subject to the provisions of ss 61 and 62.

150. The provisions of paragraph 75 (change of use of a tonnage tax asset) would also not appear apposite. If the ship on which the new expenditure was incurred were to be treated as outside the TTR for the purposes of ss135 – 156, and was then brought into use for the purposes of a tonnage tax trade (such that there was a change of use) the deferred balancing charge would immediately crystallise. That would be contrary to paragraph 72(3)(a) which provides that the company's entry into tonnage tax does not affect the operation of ss 135 – 156.

151. Those conclusions would unquestionably leave a lacuna in the legislative provisions. Resolving the lacuna may lie in the fact that paragraph 72 is included in group of provisions dealing with "entry" into tonnage tax. The Tribunal takes the view that it is conceivable that the deferred charge and thereby the new expenditure is required to be brought into the tonnage tax pool and the provisions of paragraph 77 then apply on the sale of the ship, which was the subject of the new expenditure, whilst within the TTR.

152. Whether there is a lacuna or there is a mechanism for recovery of the deferred balancing charge there is nothing in the paragraph 72 mechanism for allocation of a deferred balancing charge which indicates that the TTR acts as a substitute for the claiming of capital allowances.

Ship on which no capital allowances have been claimed is held at point of entry into tonnage tax. Ship is the subject of a disposal event whilst company under TTR

153. The parties were agreed that where a company operated a ship prior to entry into the TTR, but had not allocated the expenditure incurred as qualifying expenditure, neither the provisions of paragraph 69 nor paragraph 77 would or could apply, as there would be no UQE capable of allocation to the tonnage tax pool and paragraph 77 applies only to the disposal of ships within the tonnage tax pool.

154. The Tribunal agrees that such a view is clearly correct again confirming that the legislation does not appear to require that WDAs are deemed to have been claimed for any of the period when a qualifying ship is operated within the TTR.

Ship purchased and sold during a period when a tonnage tax election was effective

155. Where a new asset is acquired or brought into use wholly for the purposes of a tonnage tax trade, the associated expenditure does not increase the company's tonnage tax pool (paragraph 74) and no capital allowances may be claimed (paragraph 68(2)(b)). When it is sold (within the period of a tonnage tax election), no balancing allowances or balancing charges arise. The position is the same as any other asset acquired for purposes other than a qualifying activity.

156. The statutory provisions do not deem there to have been any allowances given which would need recouping as a consequence of the operation of the TTR.

Ship on which capital allowances have been claimed is held at point of entry into tonnage tax. The ship is still held at the expiry of the tonnage tax election.

157. The position at entry into tonnage tax is as described in [127] and [128] above.

158. The statutory provisions as to what happens on leaving on the expiry of an election are contained in paragraphs 68(2)(c)(i) and 85(1C) .

159. Paragraph 68(2)(c)(i) provides that, on leaving the TTR, the company "is treated as having incurred qualifying expenditure of an amount equal to the lower of cost and market value". Paragraph 85(1)(a) requires that "the amount of QE" under Part 2 CAA is to be determined by paragraph 85(1C), which again provides "the amount of QE" as the market value on exit or, if less, the amount of expenditure incurred on the provision of the asset that would have been QE if the company had not been subject to tonnage tax.

160. This language is interesting and, in the Tribunal's view, significant: paragraph 68(2)(c)(i) apparently being a deeming provision and paragraphs 85(1)(a) and 85(1C), in a more fixed way, "determining" the amount of QE which has been deemed or treated as having been incurred under paragraph 68(2)(c)(i) . In each case, QE bears the definition set out in paragraph 88 i.e. expenditure in respect of which a person *is or may* be entitled to a capital allowance.

161. Paragraph 85(1C)(b) requires that all expenditure incurred on plant and machinery used for the purposes of the tonnage tax trade is identified on an individual asset by asset basis, whether such expenditure is incurred before the TTR election was effective or after it. The provision looks back to the amount of actual expenditure meeting the description in s11(4) save for the fact that the company was subject to the TTR and compares it to the market value of the asset at exit. The amount of QE in respect of which the company is or may be entitled to claim a capital allowance is thereby determined as the lower of those two sums.

162. The provisions of paragraph 85(1C) in the main reflect the ethos of s13, which essentially provides for capital allowances to be calculated by reference to the market value of the assets when brought into use for the purposes of a qualifying activity, having previously been used for other purposes.

163. The role of paragraph 85(1C) in determining the pool to which the QE is allocated (as required in paragraph 85(1)(b)) would appear to the Tribunal to be driven by the requirement that each asset is assessed independently and the normal rules on allocation prescribed in ss 53 and 54 then apply. To that extent the Tribunal accepts HMRC's submission that allocation to a pool is mandated and the pool is identified but by reference to the interaction between paragraph 85(1)(b) and ss53 and 54 CAA. The language used in paragraph 85(1)(b) and (1C) appears to eliminate the choice inherent within the CAA as to whether and when to allocate the QE to a pool. However, what is allocated to that pool is unquestionably the figure for QE determined by paragraph 85(1C)(b).

164. A company that brings assets which had been subject to capital allowances into tonnage tax is not required to bring forward the UQE taken into the tonnage tax pool for the purpose of calculating future capital allowances after exit from TTR. The effect of these provisions is that the history on entry into tonnage tax is wiped clean and the base for capital allowances is reset.

165. These provisions determine QE as the baseline for calculating capital allowances on a go forward basis.

166. HMRC describe those leaving the TTR on the expiry of an election or on the giving of a withdrawal notice as "good leavers". It is certainly apparent that the rebasing of allowances in the manner envisaged in paragraphs 68(1)(c)(i) and 85(1C) puts such leavers in a positive position. Any balancing charge that might have arisen by reference to market value of the

assets at either entry into the TTR or exit from it, are forgiven and future allowances based on the lower of actual expenditure and market value at exit are provided for.

167. Assume that in 2004 a company acquires a ship for £14,000,000 and claims capital allowances for three chargeable periods. In 2007, the company enters the TTR and the ship has a market value of £11,200,000. In 2017, the tonnage tax election expires and the ship has a market value of £9,500,000.

Costs at acquisition	14,000,000
AQE after year 3 = UQE	5,906,250
Market value on entry to tonnage tax	11,200,000
Market value on expiry	9,500,000
QE available on exit	9,500,000

168. The difference between UQE at entry into tonnage tax and market value on exit does not give rise to a balancing charge on exit; an outcome inherent in the operation of paragraphs 77 - 79. The company is free to choose to claim capital allowances or otherwise as if having incurred that QE for the first time (see [99] above).

169. If the company then disposes of the ship, all the consequences explored in [100] to [124] will follow by reference to the circumstances as they arise but by reference to QE equal, in this example, to the market value of the ship on exit from tonnage tax.

170. Where there has been a deferred balancing charge under ss135 – 156, it is to be assumed that the "amount of expenditure incurred on the provision of the asset that would have been qualifying expenditure if the company had not been subject to tonnage tax" is the actual expenditure incurred reduced by the deferred balancing charge. However the deferred balancing charge would not be recouped where the asset value had diminished such that market value set the amount of QE.

171. HMRC accept that in this case and for "good leavers" there are no imputed or deemed WDAs as a consequence of the operation of the TTR.

Ship on which capital allowances have been claimed held at point of entry into tonnage tax. Ship continues to be used by the company but due to a change of use of the ship the company becomes ineligible to be in tonnage tax. The company continues to claim capital allowances on exit.

172. The position at entry into tonnage tax is as described in [127] and [128] above.

173. Paragraph 68(2)(c)(ii) provides that on leaving tonnage tax (for reasons other than expiry or withdrawal notification) the company is "put broadly in the position it would have been if it had never been subject to tonnage tax". It is to be noted that this was the position that subsisted for all rationales for leaving the TTR prior to 2005.

174. As with paragraph 85(1C) paragraph 85(2) determines the amount of QE under Part 2 CAA. The language of paragraph 85(2)(a) is identical to that used in paragraph 85(1C)(b): "the amount of expenditure incurred on the provision of the asset that would have been qualifying expenditure if the company had not been subject to tonnage tax". As at [161] that language is designed to catch expenditure of a company on the provision of plant and machinery used for the purposes the tonnage tax trade as if it were expenditure falling within s11(4) CAA.

175. However, unlike the favourable position advanced to "good leavers" other leavers[29] are required to be put in broadly the same position as they would have been were they not in tonnage tax.

176. As most assets depreciate over time, taking an asset out of the tonnage tax pool at a preserved UQE or at market value at exit would potentially permit significant WDAs on a go forward basis for assets that were depreciated at a time where capital allowances were prohibited. It is therefore critical to ensure that such allowances are not calculated on an inflated value of QE.

177. The methodology adopted by the legislation is therefore to rebase QE by reference to the provisions of Reg 4 TT Regs, even though post 2009 such rebasing over states the "assumed" depreciation. However, in the Tribunal's view, this assumed depreciation in value for the purposes of calculating WDAs on a go forward basis is not the same as giving or treating as having given the allowances to that point. It is simply a matter of ensuring that future WDAs claimed are not over stated.

178. That such a view is a reasonable interpretation of the provisions is confirmed by reference to the EN for paragraph 85 on introduction (which as previously stated provided only the paragraph 85(2) model for transitioning companies from within the TTR to the general capital allowances regime). The EN provides:

> "When a company leaves tonnage tax it will once again wish to claim capital allowances on expenditure incurred on machinery and plant used for the purposes of its trade. Paragraph 85(1) says that the rules in paragraph 85 should be used to determine what proportion of the company's expenditure on assets held at the time of leaving the regime will qualify for future capital allowances and which capital allowance pools that expenditure should be placed in.
>
> Those rules are set out in paragraph 85(2) which looks at the company's machinery and plant held on exit from the regime on an asset by asset basis. The amount of qualifying expenditure is calculated by taking the amount of expenditure which would have qualified for capital allowances at the time the company acquired the asset and writing down that expenditure over the period between that time and the company's exit from tonnage tax." (emphasis added)

179. That position is also consistent with the language of Reg 4 TT Regs which describes the writing down percentage as the percentage of the paragraph 85(2)(a) amount which is qualifying expenditure (by reference to paragraph 88 the amount which is or may give rise to a capital allowance).

180. Akin to s13, the notional qualifying expenditure is determined at the point at which previously owned assets are used for a qualifying activity. However, on the basis that paragraph 68(2)(b) provides that a company subject to tonnage tax is not entitled to capital allowances[30] in respect of expenditure incurred for the purposes of its tonnage tax trade, whether before or after its entry into tonnage tax, that figure of "notional expenditure" is a reduced proportion of actual expenditure incurred.

[29] HMRC refer to leavers under paragraph 68(2)(c)(ii) Sch 22 as "bad leavers". The Tribunal is uncomfortable with that term. There are valid reasons why a company may leave the TTR prior to expiry of the election or as a consequence of waiver.

[30] Which, by reference to the definition in paragraph 87 Sch 22 requires that "the expenditure shall be disregarded for the purposes of calculating the person's entitlement to writing down allowance or balancing allowance or liability to a balancing charge"

181. As with paragraph 85(1C), paragraph 85(2)'s role in determining the pool to which the QE is allocated (as also referenced in paragraph 85(1)(b)) would appear to the Tribunal to be driven by the requirement that each asset is assessed independently and the normal rules on allocation prescribed in ss 53 and 54 thereby apply. As at [163] allocation to relevant pool is not optional, the choice inherent within the CAA as to whether and when to allocate the QE to a pool is removed. However, for the reasons set out above and illustrated below the Tribunal considers that what is allocated to the pool is the amount of QE.

182. The company purchases a ship in 2004 for £14,000,000, claims capital allowances for three chargeable periods and then elects into tonnage tax in 2007. The company buys a second ship for £12,500,000 in 2009 whilst within the TTR. The company remains in the TTR until 2010 when as a consequence of no longer meeting the requirements of the TTR it becomes ineligible. The company continues a shipping trade.

183. The Tribunal has considered whether the conclusion reached in [127] that entry into tonnage tax constitutes a disposal even without a balancing charge or allowance arising impacts "the amount of expenditure incurred on the provision of the asset that would have been qualifying expenditure if the company had not been subject to tonnage tax" and has concluded that it does not. The provision in paragraph 85(2) is specific as to ignoring the company's election into tonnage tax with the consequence that the disposal even arising on that change of use too should be excluded.

184. Paragraph 85(2) therefore applies to the example at [182] as follows:

	Ship 1	Ship 2
Costs at acquisition 2004	14,000,000	
AQE after year 2 = UQE into tonnage tax pool 2006	7,875,000	
Cost of acquisition 2009		12,500,000
No of years of ownership	4 - 5	0 - 1
Percentage applied under Reg 4 TT Regs	25%	70%
QE available on exit 2010	3,500,000	9,375,000

185. As the respective assets are both ships and are required to be considered independently from one another, by virtue of paragraph 85(1)(b) each ship will be allocated to a single asset ship pool[31]. The sum so allocated is the QE identified in the table.

186. At the point of allocation to the pool, the provisions set out at [100] – [102] above apply and the company may claim WDAs on this imputed figure. For the purposes of WDAs it does not matter whether the figure is imputed as QE or AQE.

187. The difference arises only when it comes to the truing up required on the occurrence of a subsequent disposal event. On UT428's case, if the imputed figure is QE the provisions of s62(1) have the consequence that on disposal TDR is capped at the imputed figure, if HMRC are correct then the Reg 4 TT Regs reduction is deemed to have been an allowance actually claimed by the company and QE for the purposes of the s55 calculation is the cost at acquisition.

188. Taking the example at [182], assume that in the year of exit WDAs are claimed and the ships are sold one year later for £12,000,000 in the case of each of ship 1 and ship 2:

[31] Subject to s129 CAA

	Ship 1	Ship 2
QE on exit (2009)	3,500,000	9,375,000
WDA claimed in 2009 at 20%	700,000	1,875,000
AQE at the end of 2009	2,800,000	7,500,000
Receipt on disposal	12,000,000	12,000,000
TDR capped at QE UT428's case	3,500,000	9,375,000
Balancing charge AQE – TDR UT428's case	700,000	1,875,000
TDR (only capped at original cost) HMRC's case	12,000,000	12,000,000
Balancing charge AQE – TDR HMRC's case	9,200,000	4,500,000

189. In the case of ship 1, the WDAs claimed and given under CAA are £6,125,000 pre entry into the TTR and £700,000 after exit (total £6,825,000). On UT428's case, the pre entry allowances are never recouped by way of balancing charge; however, on HMRC's case a balancing charge £2,375,000 greater than the allowances in fact claimed is subject to a charge to tax.

190. In the case of ship 2 the WDAs claimed and given under CAA are £1,875,000. On UT428s case these are recouped by way of balancing charge; however, on HMRC's case a balancing charge of £2,625,000 greater than the allowances in fact claimed is subject to a charge to tax.

191. On the face of it, as regards ship 1, neither approach appears to give the correct outcome, unless it is to be concluded that the TTR does incorporate an assumed capital allowances deduction against profits in the case of leavers other than "good leavers".

192. Paragraph 68(2) is clear that, whilst entry into tonnage tax does not give rise to any balancing charge or allowance, a company in the TTR "is not entitled to capital allowances in respect of expenditure incurred for the purposes of its tonnage tax trade, whether before or after its entry into tonnage tax". Paragraph 87 defines "not entitled to capital allowances" as disregarding the expenditure for the purposes of WDAs, balancing allowances and balancing charges.

193. It therefore appears to the Tribunal that that "entitlement" might be expected to cut both ways. If, whilst within the TTR, the capital allowances regime is entirely suspended such that pre-entry claims to capital allowances are simply frozen, the company should then expect those allowances to again become relevant either when the asset is disposed of whilst within the regime or when the company itself leaves the TTR.

194. On the face of it Parliament has, in fact, chosen to apply a more favourable outcome than suspension in the majority of the scenarios considered above through the tapering provisions of paragraph 78 and the introduction in 2005 of the substitution of market value at exit for leavers of the type envisaged in paragraph 85(1A). The legislation, in those situations clearly and explicitly relieves the company of any adjustment to the capital allowances taken prior to entry into tonnage tax.

195. For companies that seek to impermissibly manipulate the favourable TTR and seek a greater tax advantage than is inherent within the regime itself, paragraphs 41, 42 and 139 impose an exit balancing charge.

196. The Tribunal is therefore limited to considering how the provisions are to be applied, where there is no impermissible tax motivation either for electing into the TTR or for leaving it.

197. The approach to interpretation of the legislative provisions is to give them the meaning ascribed by Parliament by reference to the defined terms or the natural meaning of the words used and by reference to their statutory context.

198. Expenditure and QE are different terms for the purposes of Sch 22. Paragraph 88 defines QE as "expenditure in respect of which a person is or may be entitled to capital allowances [allowances under CAA]". Paragraph 85 requires that the amount of QE on exit from the TTR shall be determined by its terms. Reg 4 TT Regs is consistent in its reference to a percentage application to a figure of expenditure resulting in a figure of QE. For companies leaving in the circumstances falling within paragraph 85(2), the determination of QE requires that expenditure be identified and written down but the product of that exercise on the language chosen by Parliament is unquestionably an amount of QE.

199. Section 57 defines AQE by reference to QE and UQE with s55 CAA using AQE as the reference point for determining whether a balancing charge is due. In an unfortunately circular way, s59 CAA then uses AQE to define UQE. Entirely consistent with the scheme of capital allowances, s62(1) limits the amount of disposal value required to be brought into account when calculating TDR by reference to QE and not AQE or UQE.

200. Whilst it may be notable that within Part IX, Sch 22 does not reference AQE, UQE and QE are used, unsurprisingly, in a way entirely consistent with the provisions of the CAA. The Tribunal considers that to interpret the provisions of paragraph 85(2) as defining either the UQE or AQE of each asset on exit from the TTR would be inconsistent with the language chosen by Parliament.

201. The Tribunal therefore considers that the product of the paragraph 85(2) calculation limits the availability of WDAs to a sum commensurate with a deemed (though possibly, by reference to the statutory rate of WDA, overstated) depreciated value of the assets. However, in choosing to determine the amount of QE and not AQE/UQE, Parliament must be taken to have chosen to do so taking account of the consequences of that decision.

202. The Tribunal acknowledges that, in doing so, capital allowances given prior to entry into the TTR may not be recouped but considers that an inevitable consequence of the statutory language used. But it does not justify the conclusion advanced by HMRC.

203. Further, the Tribunal considers that there is nothing in the provisions of the TTR which can be interpreted as deeming or even inferring that it is an inherent feature of the TTR that it substitutes a figure for capital allowances which must then be recouped through a balancing charge. As articulated at [140], [152], [154] and [171] above the Tribunal considers in fact the opposite is the case. The TTR is a discrete and ring fenced regime that simply removes the company from the capital allowances regime for the period that a tonnage tax election is effective.

204. Capital allowances cannot be claimed in respect of assets used for a tonnage tax trade. The effect of paragraph 85(2) is that they are not and cannot be claimed on a value of QE which has not first been written down. The apparent "flaw" in the provision, is that it fails to recoup capital allowances claimed prior to entry into the TTR when a company exits, but does so in the context of the provisions of paragraphs 78, 79 and 85(1C). That is perhaps why the draftsman chose to describe the post exit position as being that the company is put "broadly" in the position it would have been if it had never been subject to tonnage tax.

205. The complexity identified at [148] – [152] in relation to the disposal of a ship for which new expenditure was incurred after entry into tonnage tax and therefore falling within paragraph 72 does not arise on exit as expenditure incurred on the provision of the asset will, by virtue of paragraph 72(3)(b) be reduced by the deferred charge as it is only that reduced sum which would have been eligible to be QE were the company not in tonnage tax having been reduced in accordance with the provisions of s143.

206. The Tribunal also considers that HMRCs submissions as to the mandated allocation to a pool (which have been accepted by the Tribunal) do not advance their position. The structure of paragraph 85 is that the determination of QE under either 85(1C) or 85(2) is required by virtue of paragraph 85(1)(a). It is only once QE is determined that it is allocated to a pool in accordance with paragraph 85(1)(b). HMRCs case essentially required the allocation to a pool to intervene between the steps at 85(2)(a) and (b) ie. Identify QE, allocate that to a pool and then write it down by reference to Reg 4 TT Regs. Had the legislation been so structured the Tribunal would have agreed that was the necessary logical and structural outcome. But that is not how the legislation is structured.

Ship on which capital allowances have not been claimed prior to entry into tonnage tax and claim capital allowances on exit.

207. This scenario is that on which the Tribunal is required to adjudicate.

208. By reference to the analysis set out at [172] - [206] above, the Tribunal considers that where no claim to capital allowances has been made, the anomaly identified in [189] – [190] does not arise, as there is simply no capital allowance given and nothing to recoup. In such circumstances, the interpretation invited by HMRC produces an outcome which is, in the view of the Tribunal, inconsistent with the manner in which Parliament has sought to define the various points of intersection between the TTR and the CAA. For the reasons set out in [191] – [206] HMRCs analysis and conclusions must therefore be rejected.

209. That is sufficient to dispose of the appeal in UT428's favour.

210. However, UT428's preliminary submission was that the provisions of s64(1) determined the appeal in its favour. The Tribunal did not feel able to determine that issue first, on the basis that to do so took that provision in isolation and out of the context of the way in which the TTR and the CAA operate at their intersections.

211. As set out at [23] above, s64(1) provides that a person is not required to bring a disposal value into account in a pool for a chargeable period, if none of the QE is or has been taken into account in determining the person's AQE in the pool for that or any previous chargeable period.

212. Upon exit from the TTR, and assuming the shipping company has a qualifying activity, paragraph 85(1)(b) states that the pool to which the amount of QE identified as a consequence of paragraph 85(1)(a) shall be allocated is determined by that paragraph. On the face of the paragraph, the amount of QE does not appear to be allocated to a pool. However, as set out at [163] and [181], the Tribunal has concluded that allocation to a pool arises as a consequence of the requirement that each asset is considered independently, which then results in the expenditure being allocated to a pool in accordance with ss 53 and 54.

213. As identified at [111] above the allocation of QE to a pool does not thereby mean that it has been taken into account when determining AQE. To be so taken into account there must be a claim to WDAs made on a return for a chargeable period (and thereby neither disclaimed nor deferred). Where no claim has been made the allocation to a pool does not, in the Tribunal's view, of itself, exclude the application of s64(1). On that basis no disposal value needs to be brought into account and no balancing charge accrued in the circumstances of this appeal.

DISPOSITION

214. The facts of the present case are, in short, that UT428 never made a claim to capital allowances either before entry into the TTR or afterwards.

215. For the reasons stated above, the Tribunal considers that there is no basis, by reference to either the statutory language or the integral logic of the relationship between and interaction of the TTR and the capital allowance regime, which requires an assumption that the TTR itself constitutes a substitute for a claim to WDAs. HMRC's case requires such an assumption limited only to the circumstances where a company leaves the TTR in the circumstances envisaged in paragraph 85(2). The Tribunal considers that the language of the statute and the formulaic nature of the capital allowance regime does not support such a conclusion.

216. The Tribunal's view is that UT428 is not required to bring into account a balancing charge in the disposal of the Ship.

217. Accordingly, UT428's appeal is allowed.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

218. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

AMANDA BROWN
TRIBUNAL JUDGE

Release date: 13 November 2019